Office of City Auditor

Department of Design, Construction and Land Use
Tracking Financial Management Improvements
January 1, 1997 through September 30, 1999

November 9, 1999

November 9, 1999

The Honorable Paul Schell
Seattle City Councilmembers
City of Seattle
Seattle, Washington 98104-1876

Dear Mayor Schell and City Councilmembers:

Attached is our report, Department of Design, Construction and Land Use: Tracking Financial Management Improvements – January 1, 1997 through September 30, 1999. We performed this review in response to a request from the Department of Design, Construction and Land Use (DCLU). The purpose of the report was to evaluate the improvements DCLU has made to its financial management system since the Program and Funding Study and Resolution 29502. Our report contains several recommendations for further improvements. DCLU issued a formal response to our report, which we have attached as an appendix.

We appreciate the professionalism and assistance offered by the DCLU employees who participated in our review. If you have any questions about this report, please call me at 233-1095 or Susan Kraght, the project manager for this report, at 669-1214.

To improve our work, we request that readers of this report complete and return the evaluation form at the end of this report.

Sincerely,

David G. Jones
Deputy City Auditor

Enclosure

Office of City Auditor

Department of Design, Construction and Land Use
Tracking Financial Management Improvements
January 1, 1997 through September 30, 1999

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EXECUTIVE SUMMARY

INTRODUCTION

This audit of the Department of Design, Construction and Land Use (DCLU) was initiated in June 1999 at the request of the Department. DCLU has made significant changes since the City Council called for a program and funding study in 1995 and subsequently passed Resolution 29502 which required regulatory fees to pay for the direct and indirect costs of regulatory programs. The purpose of this audit was to evaluate DCLU's improvements to its financial management systems since the Program and Funding Study and Resolution 29502. In addition, we recommended areas for future improvement.

SUMMARY OF IMPROVEMENTS

DCLU made the following improvements to its financial management and accounting systems.

Revenues Are Now Booked To The Proper Accounting Period: Portions of DCLU revenues are not available because permit fees for application review, processing, and inspection are collected before the work is done. DCLU implemented a new policy in 1998 to estimate revenue deferral amounts.

Labor Timekeeping System Has Been Implemented: DCLU implemented a labor timekeeping system that collects labor costs for over 37 activities. The activities are supported by 60 revenue types. Future improvements to the timekeeping system will include developing a stronger correlation between labor costs and revenue sources.

Methodology for Allocation Of Administrative Costs Has Been Developed: 20 percent of DCLU's budget funds general and administrative functions. DCLU developed and implemented a system to allocate general and administrative costs to revenue sources. DCLU will continue to refine and formalize its cost allocation system.

Interest Income Allocations Are Documented And Reasonable: DCLU is allocating interest income to revenue sources based on cash receipts and estimated expenditures. This method books the interest income to the proper source.

ISSUES FOR YEAR 2000 AND BEYOND WITH RECOMMENDATIONS

The following issues are challenges DCLU faces in the coming years. With the support of policymakers, the challenges are surmountable.

DCLU Needs To Hire A Chief Operating Officer And A Chief Financial Officer To Properly Influence and Develop Sound Financial Policies: The major reason DCLU's financial and accounting policies are in need of improvement is because its organizational structure does not have adequate day-to-day leadership. DCLU does not measure up to other organizations in terms of the influence or stature of its financial management.

Reserves And Designations: DCLU management needs to establish Generally Accepted Accounting Principles and Government Accounting Standards Board compliant reserve and designation policies. Also, the policies need to address equity between revenue sources.

DCLU Has Several Options for Allocating A Portion Of Fee Revenues for Staffing Stability And Capital Improvement: City Resolutions 29502 and 29951 allow a portion of DCLU's fee revenue to be used for staffing stability and capital improvements. DCLU has several options for making these allocations. It needs to select one and develop financial policies around the selection.

DCLU's Budget Process Needs Major Rethinking: DCLU needs authority to use permit revenues to pay for its costs of issuing permits. Currently, it only has budget authority up to projected revenues. The projections are usually inaccurate because they are up to two and one half years old.

DEPARTMENT RESPONSE

DCLU generally concurred with our report's findings and recommendations (see appendix 1 for DCLU's formal, written response to the report's final draft). Furthermore, DCLU has taken action on several of the report's recommendations.

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BACKGROUND

Through fee and tax revenue, the Department of Design, Construction and Land Use (DCLU) supports four program areas: Regulating & Maintaining Compliance; Regulating Construction; Codes, Policies and Community Relations; and Regulating Land Use. The 1999 budget for DCLU is $32 million with approximately two-thirds of the budget supported by five revenue sources: permits for building development, electrical, grading, drainage, and land use. Building development fees support approximately one-third to one-half of DCLU's budget depending on the year. The General Fund supports approximately 15 percent[1] of DCLU's budget.

In 1995, the City Council called for a study of DCLU funding and programs for the purpose of establishing greater financial stability. Based on the study, Resolution 29502, adopted on December 9, 1996, required regulatory fees to pay for the direct and indirect costs of the regulatory program. Basically, the resolution required DCLU to set fees on the basis of cost. The resolution complies with Washington State RCW 82.02.020 which permits cities to collect reasonable fees from an application for permit (which covers the cost to the City) but prohibits collecting fees as a tax.

The resolution completely changed the financial management of DCLU. It required DCLU to set fees based on cost. However, DCLU's budget process was not changed (so it could manage costs based on workload) and it did not have accounting records to support cost by permit type. DCLU has been working to develop these records.

REVIEW SCOPE AND METHODOLOGY

The purpose of our audit was to determine if DCLU was progressing toward implementing financial policies that support the intent of Resolution 29502 and subsequently 29951. Our primary objective was to determine if DCLU was accurately aligning and managing costs to individual fee revenues. Our methodology included reviewing DCLU's support documentation, reviewing written methodologies, interviewing DCLU personnel, and conducting general research including reading the Program and Funding Study.

[1] Based on 1998 and 1999 actual revenues.

CONCLUSION

DCLU's progress has been remarkable given where they started. The Department has:

- Developed an accurate revenue deferral policy to ensure revenues are booked to the proper accounting period;
- Implemented a labor timekeeping system; and
- Developed an allocation methodology for administrative costs and interest income.

While DCLU has made significant progress, it still needs to:

- Realign its management structure to reflect the skills and influence needed to manage the health and integrity of DCLU's financial position;
- Continue to refine cost accounting policies to ensure a sound relationship between revenues and costs;
- Determine how to account for staffing stability and capital improvement costs while preserving cost equity between permit applicants; and
- Rethink the budgeting processes to align expenditure authority with revenues.

SUMMARY OF IMPROVEMENTS

Revenues Are Now Booked To The Proper Accounting Period

Fund accounting allows governments to recognize revenues when they become available and measurable (modified accrual basis). Portions of DCLU revenues are not available (or earned) because permit fees for application review, processing, and inspection are collected before the work is done. The portion of the revenues not earned must be deferred (to cover future costs). Prior to 1997, DCLU deferred a small portion of its revenues based on cash needs. The total deferral was approximately $1 million when fees collected, yet not earned, totaled approximately $5 to 6 million.

DCLU implemented a new policy in 1998 to estimate revenue deferral amounts. It now reviews large permits individually and small permits in aggregate to determine earned versus unearned revenue. The unearned revenue amount is classified as deferred revenue. This methodology produces an accurate estimate.

Recommendation for Continued Improvement: Deferred revenue estimating policies should be formally documented. The written policy should include exact methodology for biannually calculating deferred revenue, who is responsible for the calculation, and review and approval process. The written policies should include a provision for an annual approval by the Chief Financial Officer and the Director of DCLU.

Labor Timekeeping System Has Been Implemented

Prior to 1998, DCLU's General Management organization made educated estimates to determine the costs associated with over 60 revenue types. The estimates were derived from organizationally based budgets and expenditures. In 1998, DCLU implemented a labor collection system in which employees charge time to one of 37 activities. On a percentage basis, the activities are supported by various revenue sources. The percentages are developed based on managerial input and time studies initiated in 1999 by DCLU's General Management and Regulating Construction organizations.

Recommendation for Continued Improvement: Further define cost accounting systems that strengthen the relationship between input to the timekeeping system and costs assigned to specific revenue sources. Specifically, we recommend that DCLU:

- Discontinue dividing revenue sources into revenue types. Each revenue source should have only one code.
- Refine work activities based on correlating revenue sources. Minimize activities supported by more than one revenue source.
- Eliminate gray areas in timekeeping instructions. Make it simple for employees to charge their time to the correct code.

Methodology for Allocating Administrative Costs Has Been Developed

As DCLU's administrative costs account for over 20 percent of its budget, it is important to allocate administrative costs accurately. In 1998, DCLU developed a system to allocate administrative costs to activities based on the activity's use of administrative support. The system uses estimates to develop complex allocation percentages.

In 1999, DCLU augmented its timekeeping system to capture administrative work directly attributable to an activity. This will further ensure the accuracy of administrative cost allocations.

Recommendation for Continued Improvement: Refinement of general and administrative cost allocations should continue. Specifically, we recommend that DCLU:

- Define general and administrative versus support costs.
- Develop an allocation methodology for general and administrative costs. The methodology should be based on FTEs or total expenditures.
- Continue to collect actual cost data for support costs. Allocate support costs to revenue sources based on actual costs. Use prior actual data for budgeting purposes but use current actual data for annual cost allocations.
- Write a formal cost allocation policy that includes clear definitions, allocation methodologies, and monitoring procedures.

Interest Income Allocations Are Documented And Reasonable

Because DCLU receives "up front" money for permit applications, it earns interest income. Interest income was approximately $1.5 million for 1997-98. In 1999, DCLU developed a methodology to allocate interest income to the proper revenue sources. The methodology is based on the timing difference between cash receipts and estimated expenditures for each revenue source.[2] This accurately allocates interest income to the correct revenue source.

Recommendation for Continued Improvement: Policies for allocating interest income should be formalized through written procedures. The procedures should include methodology, timing, and responsibilities. On an annual basis, DCLU's Chief Financial Officer should approve the interest income allocations.

ISSUES FOR YEAR 2000 AND BEYOND

The following issues are challenges DCLU faces in the coming years. They should not be construed as criticisms of DCLU's current management or policies. As auditors, we would never expect DCLU to solve all issues surrounding a major accounting system change in just two and one half years.

DCLU Needs to Hire A Chief Operating Officer and A Chief Financial Officer to Properly Influence and Develop Sound Financial Policies

Figure 1 below is DCLU's top management structure. The financial responsibilities for the organization are several positions below the Director. Figure 2 below displays the structure we recommend. Financial responsibilities are elevated to the DCLU's executive level. A Deputy Director is added for operational leadership.

[2] Normalized for General Fund activities when cash receipts and expenditures occur simultaneously.

Figure 1 – Current Management Structure

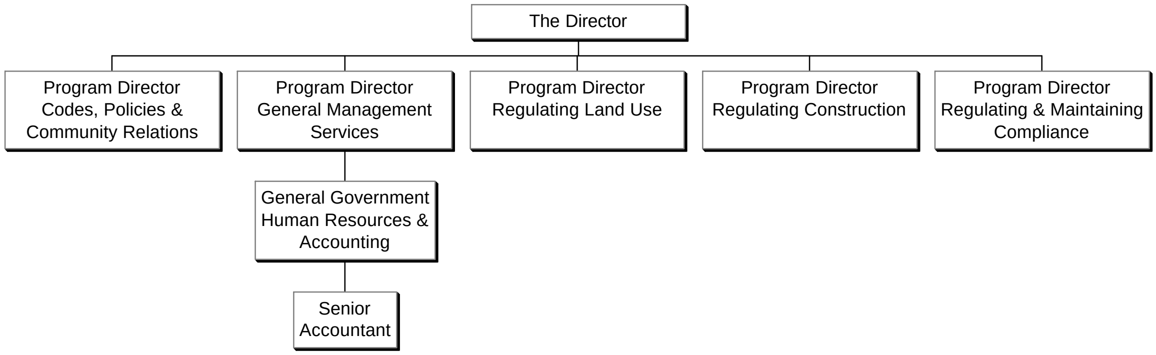
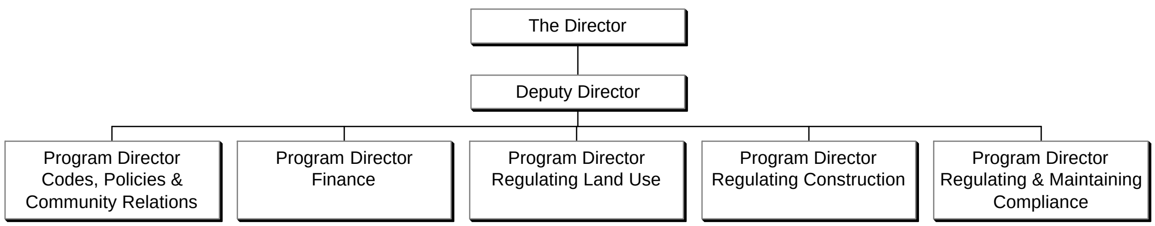


Figure 2 – Recommended Management Structure



The major reason DCLU's financial and accounting policies are in need of improvement is that its organizational structure does not promote adequate day-to-day leadership. DCLU does not measure up to other organizations in terms of the influence or stature of its financial management personnel. Complex financial policies are difficult to implement without leadership in the Director's Office and recognition that finance is as important as land use and construction programs.

In private industry (as well as the City's Parks and Recreation Department, Seattle Center, City Light, SeaTran, and Department of Housing), a Chief Executive Officer mainly focuses on external matters. A Chief Operating Officer (or Deputy Director) manages internal affairs. In complex organizations it is difficult for the top executive to meet external obligations without an operational manager. This is exactly what DCLU is trying to do. Given the difficult financial management and reporting mandates specified by the City Council, through Resolution 29951, the organization structure should be changed.

Recommendation: Use current executive and management openings to hire a Chief Operating Officer (Deputy Director) and Chief Financial Officer (Program Director). The Chief Financial Officer should have extensive finance experience in a fee-based regulated environment. The Chief Operating Officer should have some financial background as well.

Reserves and Designations

City Resolution 29951[3] (supercedes 29502) allows DCLU to reserve fund balance (revenues less expenditures) for critical staffing costs during economic downturns, technology replacement and enhancement, and strategic planning including training. DCLU's treatment of its "reserves" should be compliant with Government Accounting and Financial Reporting Standards as published by the Governmental Accounting Standards Board (GASB).

The City Resolution allows a fund balance reserve. In government fund accounting, the word "reserve" is limited to the portion of the fund balance that is not appropriate for expenditure or is legally segregated for future use.

DCLU's internal documents divide fund balance between "designated" or "undesignated". The designated fund balance is the "reserve" total. The Codification of Government Accounting and Financial Reporting Standards defines designation as follows:

> "Fund balance ***designations*** may be established to indicate tentative plans for financial resource utilization in a future period, such as for general contingencies or for equipment replacement. Such designations reflect tentative managerial plans or intent and should be clearly distinguished from reserve."

The Standards go on to say that designations should be reported as a part of unreserved fund balance and disclosed in the Notes to the Financial Statements.

Recommendation: DCLU management needs to differentiate between designations and reserves and to determine how designations and reserves correlate with City and State regulations.

DCLU Has Several Options for Allocating A Portion Of Fee Revenues for Staffing Stability and Capital Improvements

In governmental agencies or businesses, there are costs that benefit revenues (or permit applicants) from more than one accounting period. In traditional governmental accounting, the exact matching of expenditures and revenues is not required. Costs are booked to the accounting period when paid. For example, when a City department remodels its offices, the costs of remodeling are expenditures against the General Fund revenues for the current period. No one would question whether the remodeled office benefits the taxpayer in the subsequent years. If DCLU remodels its offices, current period revenues probably should not be used to pay for the remodel. (Current period

[3] Ordinance 119501 creates the restricted reserve.

permit applicants would pay for the new office while future applicants receive the benefits.)

Resolutions 29502 and 29951 were created to solve the problem described above. It states:

> "In determining whether revenues and costs are roughly proportional, it is appropriate to consider deferred liabilities and the need for reserves for such things as seasonal or other fluctuations in revenues, acquisitions and/or improvements of technology, and strategic planning and implementation, including training and equipment."

DCLU has internally reported "reserves" on fund balance for staffing stability, technology enhancements, and other capital programs. It developed a general methodology that allocated "reserve" amounts for each revenue source. However, the fund balances for some revenue sources (depending on the year) were not reserved against. DCLU needs to develop and apply an equitable reserve methodology.

DCLU is in a position to fund staffing stability and capital improvements in a number of different ways. The following outlines two methods that are GASB compliant and were developed to promote "charging a permit applicant the cost of processing the permit".

Method #1 – Revise Current "Reserve" Strategy

Systematically develop an equitable staffing stability (or general economic downturn designation that includes non-labor costs) "designation" methodology that treats all revenue sources and application years as equally as possible. Although it may take years to develop a fair methodology, as DCLU is still refining fee setting and cost accounting mechanisms, it will be worth the effort in the long run.

The "reserve" methodologies would be developed over time but Method #1 includes the following concepts:

- Strategic planning is considered an administrative cost and should be equitably allocated to all activities.
- All downtime (employees without applications to review, process, or inspect) must be identified as such for this system to work properly.
- Capital improvements, including large technology projects and large five year plan projects would be capitalized for cost accounting purposes. Each improvement project would be depreciated over a useful life for cost accounting purposes.

For cost accounting purposes, a Special Revenue Fund may consider depreciation. <u>The Codification of Government Accounting and Financial Reporting Standards</u> states:

> "Depreciation of general fixed assets may be recorded in a cost accounting system or calculated for cost finding analyses; and accumulated depreciation may be recorded in the General Fixed Asset Account Group".

Reserves should normally not fund capital improvements or projects because current permit applicants are paying for the improvements while future permit applicants are receiving the benefits.

Method #2 – Change From A Special Revenue Fund To An Enterprise Fund

Since DCLU receives the majority of its revenues from providing services to the public, and the cost of services is recovered from fees, it could change from a Special Revenue Fund to an Enterprise Fund. The major advantage of switching is that DCLU's financial accounting and cost accounting could be one and the same. DCLU could capitalize and depreciate capital expenditures. Reserves are allowed under Enterprise Fund accounting but Generally Accepted Accounting Principles (GAAP) requires that (1) the amount needed for the expense (covered by the reserve) must be measurable and (2) there is a probable likelihood of needing the reserve. In addition, reserves against retained earnings are legally restricted. Designations are not normally used in Enterprise Fund accounting.

The above methods are not the only two methods for accounting for staffing stability or capital projects. Whatever accounting methods DCLU elects to adopt, it must be GASB compliant and provide assurances to policymakers, elected officials, and permit applicants that DCLU is charging regulatory fees based on the cost to review, process, and inspect.

Recommendation: Develop a GASB compliant financial accounting system and equitable cost accounting methodology to fund staffing stability and capital improvements in a logical, consistent manner. Specifically, we recommend that DCLU:

- Determine what type of accounting best fits DCLU: Government or Enterprise Fund Accounting.
- Understand accounting requirements and options for funding staffing stability or economic downturn "reserves" by researching GASB and Government GAAP.
- Develop written policies to include financial accounting procedures, reconciliation between financial and cost reporting, and responsibilities for implementation and approval.

DCLU's Budget Process Needs Major Rethinking

DCLU submits a budget request that is similar to that of other City organizations. Its budget request is supported by revenue forecasts. Since the City adopts a biannual budget, DCLU forecasts revenues up to two and one half years in advance of accepting applications associated with the revenues. In the past few years, revenues have exceeded forecasts. However, DCLU's budget has not increased accordingly.

One could compare DCLU's situation to a grocery store. If business increases, the grocery store adds clerks, meat cutters, deli workers, and stockers. If revenues and costs actually go hand in hand, DCLU needs additional resources when revenues exceed projections. In the case of the grocery store, check-out lines are long, the shelves are empty, and the prepared food is dated. The revenues received by DCLU are not General Fund monies and, according to State law, can only be used for the purpose for which they are received. The City gains no benefit by not allowing DCLU budget authority up to the level of revenues earned.

DCLU should have the authority to use permit revenues to pay for its costs of issuing permits. Seattle Center has similar authority in that it is allowed (through City Ordinance) to spend Admission Tax revenues beyond those projected. In contrast, DCLU should not be allowed to spend budget authority if revenues are less than projected. At that point, reserves for staffing stability or economic downturn could be used.

Recommendation: DCLU should request assistance from the City Attorney to draft an ordinance similar to that of Seattle Center. The ordinance should authorize the expenditure of revenues, beyond those estimated in the adopted budget, specifically for offsetting the cost of earning the revenues. The ordinance could also reduce expenditure authority if revenues are lower than estimated.

To offset the risks associated with its additional expenditure authority, DCLU should undergo an annual review by the City Auditor or an outside Certified Public Accountant. The purpose of the review would be to determine whether costs allocated to revenue sources are accurate and reasonable, and are based on sound financial policies.[4]

[4] The audit would only be performed if City officials were interested in such a review.

City of Seattle

Paul Schell, Mayor

Department of Design, Construction and Land Use
R. F. Krochalis, Director

November 3, 1999

David G. Jones
Deputy- City Auditor
1100 Municipal Building
600 Fourth Avenue
Seattle, Washington 98104-1876

Dear Mr. Jones:

Thank you for the opportunity to comment on your final draft report, "Department of Design, Construction and Land Use - Tracking Financial Management Improvements - January 1, 1997 through September 30, 1999." I am pleased to report that DCLU has already taken action on several of the recommendations your Office presented.

Chief Financial Officer (CFO): As a critical first step in strengthening our financial management and organizational structure, I have hired a Chief Financial Officer, effective December 1, 1999. The CFO joins DCLU as a peer among the directors of the operations units in order to provide strong, focused leadership on DCLU's financial management and reporting systems.

Continued Improvements

Revenues booked to the proper accounting period: The department has documented the deferral methodology described in the Auditor's report. I expect to formalize this methodology by May 2000, so that written policies are in place at the time we determine our mid-year deferrals. Both the Chief Financial Officer and Department Director will approve DCLU's biannual deferrals.

Labor timekeeping system: The department is committed to refining the cost accounting and timekeeping systems. Discussions about cost coding refinements are underway and will be completed during 1st quarter 2000, in preparation for the 2001-2002 budget process. Although universal one-to-one relationships between cost codes and revenue sources are not possible, I expect to improve these linkages. It is important to note that, in some cases, the goal of fitting cost coding to revenue sources competes with the department's need to aggregate costs into meaningful management units. I expect to develop a balance that will support both our financial tracking and management needs.

Administrative cost allocation: The department will continue to refine DCLU's general and administrative cost allocation methodology. Under the leadership of our new Chief Financial Officer, I expect to have an updated, interim cost allocation policy in place by the end of 1st Quarter 2000, and to follow this with a formal, written policy by December 2000.

Interest income allocation: The department has documented the interest income methodology described by the Auditor. I expect to formalize this methodology through written policies and procedures during 1st quarter 2000. Both the Chief Financial Officer and Department Director will approve DCLU's annual allocations.

Issues for 2000 and beyond

Management structure - Chief Operations Officer: The department is currently studying the cost, value and role of a Deputy Director/Chief Operations Officer The position of Deputy Director is not reflected within the 2000 budget proposal now before Council, but the Executive does support this recommendation If the position is not authorized within the 2000 budget, I will identify options for organizational structures and funding that can be considered within the 2001-2002 biennial budget process.

Reserves/designations -- staffing stability and capital improvements: Under the leadership of DCLU's new Chief Financial Officer, I expect the department to determine an appropriate fund structure. Once decided, the department will position itself to-meet the legal standards for our reserves and/or designations. DCLU is currently moving in directions that are consistent with the Auditor's recommendations:

- Capital Improvements: DCLU will finance our major technology investments through internal debt financing and depreciation of the costs over the life of the system, rather than by reserving in advance of the expenditure. I expect the department to use similar financing strategies for other major outlays that benefit future customers, based on our fund structure and our refined cost coding systems.

Staffing Stability (including non-labor): DCLU will develop a funding strategy and work plan to identify the levels of core staff needed through varying scenarios of economic downturns. Our strategies will identify how much funding is needed for the various scenarios, the most appropriate time period over which to contribute to the reserve, how to build the cost into fee design, etc. I expect this work to begin in 2000.

Budget Process Changes: I will ask our new Chief Financial Officer to collaborate with the Central Budget Office to develop options for flexibility in our budget authority as part of the 2001-2 budget process. This flexibility to manage and spend up to the level of earned revenues is critical to our ability to manage and serve our customers through economic cycles.

I look forward to continued interactions with you and your staff as the department addresses your recommendations and other improvements in DCLU's financial management systems.

Sincerely,

[*signature removed for security purposes*]

R- F. Krochalis
Director

Cc: Mayor Schell